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REDACTED - FOR PUBLIC INSPECTION

June 13, 2005

Marelene Dortch, Secretary
Federal Communications Commission
445 12th Street, S.W.
Washington, D.C. 20554

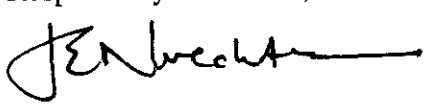
Re: *Special Access Rates for Price Cap Local Exchange Carriers*, WC Docket No. 05-25, RM-10593

Dear Ms. Dortch:

Enclosed for filing in the above referenced proceedings please find the original and nine (9) copies of the **REDACTED** version of the Comments of SBC Communications Inc. The confidential and unredacted version of the Comments is being filed under separate cover.

I am also providing an additional copy of the Comments to be file-stamped and returned to me. Please contact me at 202-663-6850 if you have any questions.

Respectfully submitted,



Jonathan E. Nuechterlein

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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
Special Access Rates for Price Cap Local Exchange Carriers	)	WC Docket No. 05-25
AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services	)	RM-10593

COMMENTS OF SBC COMMUNICATIONS INC.

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June 13, 2005

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INTRODUCTION AND SUMMARY

The composition of this Commission has changed repeatedly since the early 1990s, and its policies on many issues have changed as well. But if there has been one constant in the Commission's regulatory philosophy during that period, it has been a commitment to the cultivation of a free market for special access services. In this proceeding, the Commission will decide whether to stay that course or, instead, ignore the fruits of its own free market policies and revert to a command-and-control regime better suited to the natural monopoly conditions of the 1970s.

The Commission's special access pricing rules—including price caps generally, CALLS, and the pricing flexibility rules—have all been designed to "act[] as a transitional regulatory scheme until the advent of actual competition makes price cap regulation unnecessary."[1] Those rules are intended "to facilitate the *removal* of services from price cap regulation as competition develops in the marketplace,"[2] for the Commission's central objective is to help competition "replace[] regulation as the primary means of setting prices."[3] This free-market policy reflects the Commission's longstanding recognition that, as throughout the rest of the economy,

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1 First Report and Order, *Price Cap Performance Review for Local Exchange Carriers*, 10 FCC Rcd 8961, 8965 ¶ 1 (1995) ("*LEC Price Cap Review Order*"); *see id.* at 8989 ¶ 64 ("[W]e adopted the current price cap system which, we believed, was not only superior to rate-of-return regulation, but could also act as a transitional system as LEC regulated services became subject to greater competition."); *see also* Order and Notice of Proposed Rulemaking, *Special Access Rates for Price Cap Local Exchange Carriers; AT&T Corp. Petition for Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, 20 FCC Rcd 1994, 1999 ¶ 12 (2005) ("*Notice*").

2 Order, *Ameritech Operating Companies Petition for Pricing Flexibility for Dedicated Transport and Special Access Services*, WBC/Pricing File No. 05-14, DA 05-1525 ¶ 3 (rel. May 25, 2005) (emphasis added).

3 Fifth Report and Order and Further Notice of Proposed Rulemaking, *Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers*, 14 FCC Rcd 14221, 14224 ¶ 2 (1999) ("*Pricing Flexibility Order*").

"competition can be expected to carry out the purposes of the Communications Act more assuredly than regulation" ever could and that regulation is therefore appropriate "only where and to the extent that competition remain[s] absent in the marketplace."[4] Indeed, "[a]s the market becomes more competitive, [pricing] constraints become counter-productive,"[5] for they thwart competition by "giv[ing] the new entrants false economic signals" and reducing the margins needed to make competitive entry profitable.[6]

Competition has progressed precisely as the Commission expected. Indeed, the special access market today is vastly more competitive than it was when pricing flexibility was adopted. In SBC's Phase II MSAs, for example, the average number of active special access competitors has nearly doubled since 1999.[7] And all trends point to continuing growth in intra- and intermodal competition throughout the United States. In OCn-level services—the highest revenue special access service area, where competitors naturally emerged first—the price cap ILECs are now minority players.[8] These services have become competitive not only in dense metropolitan areas, but on a nationwide basis, as the Commission recognized in the *Triennial Review Order*.[9] And competitors are now aggressively challenging the ILECs for DSn-level

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4 *LEC Price Cap Review Order* at 8989 ¶ 64.

5 *Pricing Flexibility Order* at 14233 ¶ 19.

6 Report and Order and Notice of Proposed Rulemaking, *Expanded Interconnection with Local Telephone Company Facilities; Amendment of the Part 69 Allocation of General Support Facility Costs*, 7 FCC Rcd 7369, 7451 ¶ 172 (1992), *vacated on other grounds and remanded, Bell Atlantic Tel. Cos. v. FCC*, 24 F.3d 1441 (D.C. Cir. 1994).

7 Declaration of Parley C. Casto ("Casto Decl.") ¶ 6 (Tab A).

8 *Id.* ¶ 7.

9 Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers, Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, Deployment of Wireline Services Offering Advanced Telecommunications Capability*, 18 FCC

special access services through both independent fiber facilities and intermodal technologies that bypass ILEC networks altogether. Even DS1 end-user channel terminations are now regularly offered—in Tier II and Tier III MSAs, as well as in major metropolitan areas—by CLECs, cable companies, and fixed wireless providers. In short, actual or potential competition abounds at all levels of the market, exerting powerful constraints on ILEC special access pricing.

Given the unmistakable trajectory towards greater competition at all levels of the special access market, the next step should be clear: the Commission should continue the transition it set in motion so that market forces, rather than regulation, will drive the future of special access services. But the *Notice of Proposed Rulemaking* focuses instead on the proposals of a few special access customers to reimpose onerous pricing rules that the Commission began phasing out in the 1990s—before competition had matured to today's levels, before there was any intermodal special access competition at all, and before Congress adopted, in the 1996 Act, a national policy "[t]o *promote competition and reduce regulation* in order to secure lower prices and higher quality services for American telecommunications consumers and encourage the rapid deployment of new telecommunications technologies."[10] Following the lead of these few customers, the Commission asks whether it should use rate-of-return analysis to "re-initialize" the special access rates that ILECs may charge, thereby converting price cap regulation into rate-

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Rcd 16978, 16985-92, 17168-70, 17321-23 ¶¶ 7, 315-18, 537-41 (2003) ("*Triennial Review Order*"), *vacated in part sub nom. United States Telecomms. Ass'n v. FCC*, 359 F.3d 554 (D.C. Cir. 2004) ("*USTA II*"), *cert. denied, National Ass'n of Regulatory Utility Comm'rs v. United States Telecomms. Ass'n*, 125 S. Ct. 313 (Oct. 12, 2004), *on remand*, Order on Remand, *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, WC Docket No. 04-313, CC Docket No. 01-338, FCC No. 04-290 (rel. Feb. 4, 2005).

[10] Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56, 56 (codified at 47 U.S.C. § 609).

of-return regulation in all but name, and then further reduce the resulting rates each passing year by means of a new X-factor.

That approach would be gravely misguided. To begin with, given the growth of competition, it would border on the absurd to intervene in the special access market *more* intrusively today than the Commission deemed appropriate—with judicial approval—half a dozen years ago.[11] If special access prices *were* in some sense "too high" today, which they are not, the extra margins available to competitors would accelerate the pace of competitive entry, as the result of the very market forces that the Commission and Congress thought should govern.[12] Conversely, reducing or eliminating margins in special access would correspondingly limit competitive entry. But these anti-competitive effects are of little concern to the advocates of re-regulation because their only agenda is to seek an immediate price break from the government, without regard for the bleak long-term consequences of such intrusive intervention. Indeed, they ask the Commission to throw in the towel on the entire transition to market-based discipline of special access services and prices.

The Commission should decline that invitation, not just because competition is developing as hoped, but because there is no basis for the suggestion that ILEC special access rates are excessive. In fact, the prices customers are actually paying for SBC special access services in Phase II MSAs—most easily measured by SBC's average revenue per unit—have declined, not risen as some have alleged, since pricing flexibility began.[13]

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11 *See WorldCom v. FCC*, 238 F.3d 449 (D.C. Cir. 2001).

12 *Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398, 407-08 (2004).

13 As a general matter, even SBC's tariffed base rates in MSAs where SBC has received Phase II pricing flexibility have not increased, even in nominal terms, above those in effect in

Of course, even if ILECs *had* responded to Phase II pricing flexibility to impose substantial increases in their base rates, that in itself would say nothing about the competitive pressures present in Phase II MSAs. Rates "rise" (or "decline") only from some benchmark—in this case, regulated price caps. There is no reason to believe that, after years of annual X-factor reductions to special access rates, those price caps are at or above competitive levels; in many markets, they may well be below those levels. Indeed, it is precisely because government regulation is so fallible as a tool for setting rates at "competitive" levels that Congress and the Commission seek, as much as possible, to rely on market forces to perform that task. To assume, therefore, as proponents of re-regulation do, that any price increase over a regulated rate demonstrates market power is to ignore the infirmities of rate regulation. And when rates increase in a market in which there is *some* level of competition, as there is for all special access services, it is more likely a simple shift to competitive equilibrium than an exercise of market power.[14]

With little else to turn to, the advocates of regulatory retrenchment cite ARMIS data as supposed evidence that the BOCs enjoy prodigious rates of return on special access investment, which, they say, would be impossible in a genuinely competitive environment. This is nonsense. To begin with, ARMIS data have never provided any basis for assessing real-world economic returns, because they reflect arbitrary allocations of shared and common costs, spread among

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2001—when Phase II pricing flexibility was first implemented in SBC's territory. *See* Casto Decl. ¶ 56 (discussing DSn-level services specifically). At the same time, SBC's discount plans and contract tariffs have enabled customers to enjoy substantial savings from those base rates.

[14] *See* Declaration of Professor Joseph P. Kalt ("Kalt Decl.") ¶ 69 (Tab B); *see also Pricing Flexibility Order* at 14301 ¶ 155 (explaining that, following attainment of Phase II pricing flexibility, "some access rate increases may be warranted, because our rules may have required incumbent LECs to price access services below cost in certain areas").

multiple jurisdictions. And it has become even more meaningless to rely on ARMIS-based returns since 2001, when the Commission froze the percentage of each BOC's total costs allocated to interstate special access services. Because those services have since grown considerably as a total percentage of BOC operations, the ARMIS freeze created a radical mismatch between the reported *revenues* for those services, which reflect the actual revenues that have risen with demand, and the reported *costs* of providing those services, which are based on outdated allocations. The accounting freeze keeps those reported costs artificially small in comparison with reported revenues, grossly understating the greatly increased investment each BOC has made for such services to meet the explosive demand for ever more sophisticated data services.

Even if the ARMIS rate-of-return figures were remotely reliable, moreover, it would be arbitrary to scrutinize the figures for wholesale special access services in isolation from the rest of a price cap LEC's operations, and to re-regulate the former without addressing how doing so would affect overall returns. In the face of growing competition, the aggregate BOC rate of return for interstate and intrastate services has declined from approximately 16% in 1999 to just 13% in 2004.[15] The Commission may not arbitrarily force those returns lower still by slashing the margins that BOCs earn in some markets, such as special access, while leaving intact a regulatory system that forces the BOCs to provide ubiquitous service at unprofitable rates in other markets as carriers of last resort. Put differently, the Commission may not re-regulate special access services to produce lower returns unless it simultaneously acts to ensure that returns in other regulated markets are increased to levels that ensure sufficient overall returns.

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15 *See* Declaration of David Toti ("Toti Decl.") ¶ 39 (Tab C).

Among other things, that might require the Commission to face up to its responsibility to implement comprehensive universal service reform.

Finally, the re-regulation contemplated by the *Notice* would be not just unwarranted and arbitrary, but in conflict with the consumer benefits of greater special access competition. If, for example, the Commission were now to backtrack from price flex policies and "re-initialize" rates to take back ILEC efficiency gains, thereby reintroducing rate-of-return regulation through the back door, it would sharply reverse pro-competitive trends in several ways. *First*, artificially lowering ILEC special access rates would undermine the ability of competitive providers to earn attractive returns on invested capital in the special access market—the primary, and usually the only, reason competitive providers enter any market. As the Commission itself observed in 2000, any abrupt new constraint on prices for high-capacity circuits would "undercut the market position of many facilities-based competitive access providers," a "mature source of competition in telecommunications markets."[16] *Second*, re-regulation of special access would undermine trust in the Commission, leading current providers and future potential entrants to ignore economic "invest" signals—or to abandon efforts to improve efficiency and reduce rates—lest the Commission again overrule the market and dramatically lower expected returns on any new capital they invest.[17] *Third*, any effort to "re-initialize" rates, or to prescribe a new "X-factor" to

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[16] Supplemental Order Clarification, *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996,* 15 FCC Rcd 9587, 9597 ¶ 18 (2000), *aff'd, Competitive Telecomms. Ass'n v. FCC*, 309 F.3d 8 (D.C. Cir. 2002).

[17] *See generally* Sixth Report and Order in CC Docket Nos. 96-262 and 94-1; Report and Order in CC Docket No. 99-249; Eleventh Report and Order in CC Docket No. 96-45, *Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Low-Volume Long Distance Users; Federal State Joint Board on Universal Service*, 15 FCC Rcd 12962, 13034 ¶ 174 (2000) ("*CALLS Order*") (noting that "the controversy regarding the current status of the X-factor and the concurrent uncertainty over the resolution of the controversy disrupts

reflect supposed "productivity" enhancements, would subject the industry to years of litigation and regulatory uncertainty, as the Commission's previous forays into this area have shown.[18]

* * *

After SBC merges with AT&T, the combined company will no longer be primarily an ILEC nor primarily an IXC or CLEC, but a unique hybrid company with an interest in commercially reasonable special access rates both within and outside of SBC's traditional service region. From that perspective, SBC urges the Commission to reaffirm the basics of its existing special access regime but fine-tune the rules to allow market forces to govern more directly where competition has taken hold:

- While the Commission should retain its pricing flexibility triggers as a general matter, and should continue to apply them on an MSA-wide basis, it should treat those triggers as having been met nationwide, for *all* MSAs, for all OCn-level services and packet-switched services. The Commission already has found that there are no barriers to entry for such services, and competitive entry is robust. In fact, SBC has become a minority player in the OCn space. Rather than requiring a needless MSA-by-MSA evaluation of whether the trigger has been met (as has been the case for OCn-level services under the current framework), the Commission should determine that competition for these services makes regulation not only unnecessary but harmful, and should thus adopt a blanket rule granting Phase II-like relief for such services.

- The Commission should embrace the broad consensus that ILECs should have unlimited downward (Phase I) pricing flexibility for *all* special access services. Universal Phase I-style pricing flexibility would tremendously simplify commercial negotiations, and would make it much easier for special access purchasers to exploit the intense competition to supply high-capacity special access services in order to win cost savings on less competitive services. Special access customers themselves have asked for this broad pricing flexibility, and there is no reason to deny it. ILECs cannot feasibly engage in predatory pricing (*i.e.*, pricing below average variable cost

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business expectations and future investment decisions of both LECs and new entrants."). *See also* Kalt Decl. ¶ 69.

[18] *See United States Tel. Ass'n v. FCC*, 188 F.3d 521 (D.C. Cir. 1999) ("*X-Factor Decision*") (invalidating X-factor as unsupported by substantial evidence of productivity enhancements).

for the purpose of excluding competitors), and any accusation of such conduct could be adequately addressed in any event by antitrust law or the section 208 complaint process.

- The Commission should streamline its current basket structure for special access services by replacing the existing four service categories with two: (i) DS3-and-below channel terminations to end users and (ii) all other DS3-and-below special access services that remain subject to price caps. This approach would better align the basket structure with marketplace and regulatory realities, a revision that is long overdue. And consistent with the Commission's criteria for price cap baskets, this approach would group together services with similar competitive and technological characteristics.

These adjustments will enable the Commission to align its prevailing free-market philosophy with the public interest in maintaining some residual regulatory oversight where the market has not yet completed the transition to full competition.

DISCUSSION

I. The Current Pricing Flexibility Regime Is Working.

No longer confined to a handful of densely populated metropolitan areas, special access competition extends throughout all the MSAs in which SBC has obtained pricing flexibility. Indeed, as noted above, the average number of active competitors in SBC's Phase II MSAs has nearly doubled since 1999.[19] And, since 1996, these competitors have invested nearly $75 billion in new facilities and increased their fiber-route miles by 590%, mostly to target the price cap LECs' special access and enterprise customers.[20] That competitive progress shows, among other things, that the Commission's Phase II triggers reasonably gauge the level of competition

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[19] Casto Decl. ¶ 6. As Professor Joseph Kalt notes, the steady nature of the increase is good evidence that the new competition is not the result of a "euphoric" short-lived burst following deregulation. Kalt Decl. ¶ 35.

[20] *See* UNE Fact Report 2004, *Unbundled Access to Network Elements; Review of the Section 252 Unbundling Obligations of Incumbent Local Exchange Carriers*, filed in WC Docket No. 04-313, CC Docket No. 01-338, filed Oct. 4, 2004, at I-7 ("UNE Fact Report 2004").

within an MSA. In fact, as the Commission has explained, "evidence of collocation"—the basis for the pricing flexibility triggers—"may *underestimate* the extent of competitive facilities within a wire center, because it fails to account for the presence of competitors that do not use collocation and have wholly bypassed incumbent LEC facilities."[21] And competitive entrants continue to cut their special access prices substantially in all of SBC's markets,[22] forcing SBC to respond with price cuts and service enhancements of its own.[23] In short, the special access market is developing exactly as the Commission had hoped when crafting its current rules.

A. The Evidence of Substantial Competitive Entry in the Special Access Market Is Indisputable.

1. OCn-level and packet-switched services are robustly competitive.

As the Commission recognized in the *Triennial Review Order*, "[r]ecord evidence reflects competitive deployment of loops at the OCn level and competitive carriers confirm they are often able to economically deploy these facilities to the large enterprise customers which use them . . . , including [customers in] Tier II and Tier III markets."[24] Those findings, although made in the context of high-capacity loop unbundling, apply with equal force to the contestability of equivalent OCn-level services in the special access market. The same is true of

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21 *Pricing Flexibility Order* at 14274 ¶ 95 (emph. added); *see* Part III below (discussing how intermodal competitors and entrants using "carrier hotels" evade detection under Commission's triggers).

22 *See* Casto Decl. ¶ 57. As Mr. Casto demonstrates in his declaration, special access competition extends *beyond* the MSAs in which SBC has obtained pricing flexibility. *See* Casto Decl. ¶¶ 34-35.

23 *See id.* ¶¶ 61-66.

24 *Triennial Review Order* at 17168 ¶ 315 (finding no impairment in the market for OCn-level fiber loops). On appeal, the D.C. Circuit accepted the Commission's finding. *See USTA II*, 359 F.3d at 576.

the Commission's findings in the *Triennial Review* proceeding that packet switching is available from a range of competitors who are aggressively pursuing the incumbents' customer base.[25]

These findings, moreover, square with SBC's experience. Competition is so entrenched at the OCn level that competitors have succeeded in winning the lion's share of this business within SBC's traditional service region.[26] Throughout that territory, competitors have built a myriad of alternative fiber facilities over which competitors are actively serving high-capacity special access customers.[27] Moreover, although the impact of intermodal competition is felt most sharply at the DS1 and DS3 levels, as described below, cable and fixed wireless providers are now also offering special access services at the OC48 level and higher.[28]

The proliferation of such competition illustrates that the revenue opportunities amply support competitive entry and that there are no countervailing *barriers* to such entry. Thus, while the specific numbers of competitors for these services may differ from market to market, entry is readily possible in *all* markets. And as the Commission has traditionally recognized, the constant threat of potential competition exerts much the same disciplining effect on the market as existing competition.[29]

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25 *Triennial Review Order* at 17321-22 ¶ 538 ("[T]he record shows that a wide range of competitors are actively deploying their own packet switches, including routers and DSLAMs to serve both the enterprise and mass markets, and that these facilities are much cheaper to deploy than circuit switches.") (internal footnotes omitted).

26 Casto Decl. ¶ 7.

27 *See id.* ¶ 11.

28 *Id.* ¶ 39, 45.

29 *See, e.g.*, *Pricing Flexibility Order* at 14264 ¶ 80 (concluding that incumbent LECs' incentives will be constrained by "the extent to which competitors have made sunk investments in facilities used to compete with the incumbent LECs"; such equipment "remains available and capable of providing service in competition with the incumbent, even if the incumbent succeeds in driving [the competitors] from the market"); Report and Order, *2000 Biennial Regulatory*

In this context, continued regulation, particularly rate regulation, is not only unnecessary but also counterproductive. It is unnecessary because, in competitive markets, consumers can switch to competitive suppliers, and that dynamic disciplines any firm that fails to provide the prices and types and quality of services demanded by consumers. Such regulation also is counterproductive because it is a blunt and unwieldy instrument that distorts markets and reduces allocative efficiency by limiting carriers' ability to respond quickly to changes in demand, imposing costs that ultimately are borne by consumers. Indeed, the Commission has long recognized as much, and therefore consistently has decreased regulation where competition is taking hold.[30] It should do so here as well.

Review Spectrum Aggregation Limits For Commercial Mobile Radio Services, 16 FCC Rcd 22668, 22680 ¶ 28 (2001) ("In evaluating CMRS markets, we consider both actual and potential competition. In general, potential competition can be as important as actual competition in promoting desirable outcomes."); *see also* Memorandum Opinion and Order, *Petitions for Forbearance Pursuant to 47 U.S.C. § 160(c)*, 19 FCC Rcd 21496, 21505-07 ¶ 22 (2004) ("The broadband market is still an emerging and changing market, where, as the Commission previously has concluded, the preconditions for monopoly are not present. In particular, actual and potential intermodal competition informs rational competitors' decisions concerning next-generation broadband technologies.") (footnotes omitted); Memorandum Opinion and Order, *Petition of General Communication, Inc. for a Partial Waiver of the Bush Earth Station Policy*, 11 FCC Rcd 2535, 2536 ¶ 6 n.21 (1996); Second Report and Order, *Implementation of Sections 3(n) and 332 of the Communications Act Regulatory Treatment of Mobile Services*, 9 FCC Rcd 1411, 1470 ¶ 148 (1994); *see generally United States v. Falstaff Brewing Corp.*, 410 U.S. 526, 532-33 (1973); *FTC v. Procter & Gamble Co.*, 386 U.S. 568, 581 (1967); *United States v. Baker Hughes, Inc.*, 908 F.2d 981, 988 (D.C. Cir. 1990) ("[T]he *threat* of entry can stimulate competition in a concentrated market, regardless of whether entry ever occurs.").

[30] *See* Further Notice of Proposed Rulemaking, *Policies and Rules Concerning Rates for Competitive Carrier Services and Facilities Authorization Therefor*, 84 F.C.C.2d 445, 448-55 ¶¶ 11-14, 20 n.14 (1981); Second Report and Order, *Policies and Rules Concerning Rates for Competitive Carrier Services and Facilities Authorization Therefor*, 91 F.C.C.2d 59, 60-62 ¶¶ 1, 12 (1982) (concluding that the discipline of the market is far more effective at allocating resources and protecting consumers than regulation). Congress too has recognized that competition is superior to regulation, and has therefore required the Commission to scale back or eliminate regulation in response to growing competition. *See* 47 U.S.C. § 161 (requiring the Commission biennially to review all regulations issued under the Act to determine if they no longer are necessary due to competition).

2. DSn services are becoming increasingly competitive.

Recent economic and technological developments have similarly spurred competitive entry into the DS1 and DS3 market segments throughout SBC's region.

First, the bulk of SBC's existing lower-bandwidth special access customers are served out of a small number of wire centers. Indeed, over **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** of SBC's DSn special access revenues are derived from just **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** of its wire centers.[31] Competitors targeting these dense areas have access to the vast majority of SBC's market. It is not surprising, therefore, that competitors' fiber networks run close to a large proportion of SBC's DS1 and DS3 customers. An overwhelming percentage of SBC's DS1 and DS3 demand runs within 1,000 feet, or about three city blocks, of existing alternative fiber, as shown in the fiber maps attached to the Declaration of Parley Casto, Executive Director of SBC's special access business unit.[32] From this distance, a competitor could deploy a fiber loop to a customer for as little as **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION].**[33] In Dallas, for example, **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** of SBC's DS1 demand is within 1,000 feet of

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[31] Casto Decl. ¶ 12. For the BOCs overall, 80% of special access revenues come from just 18% of wire centers. UNE Fact Report 2004 at III-8.

[32] In 30 Phase II MSAs across SBC's territory, approximately **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** of DS1 demand and **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** of DS3 demand is within this distance. *See* Casto Decl. Attach. 2.

[33] Casto Decl. ¶ 15. Even if the provider needed to deploy conduit in a dense urban area, the cost should not exceed **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** *Id.*

competitive fiber, and **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** of its DS3 demand; in Chicago, those respective percentages are **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** and **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]**. But the same holds true even in smaller MSAs such as the St. Louis region, where **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** of SBC's DS1 services and **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** of its DS3 services are within 1000 feet of competitor fiber, and Madison, Wisconsin (one of the smallest MSAs in SBC's region), where **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** of SBC's DS1 and DS3 demand are within 1,000 feet of competitively deployed fiber.[34]

Even these numbers understate, probably significantly, the percentage of SBC's DS1 demand that is adjacent to existing CLEC fiber. As Mr. Casto makes clear, the fiber maps attached to his declaration depict only known CLEC fiber routes based on data obtained by SBC's vendor. These data are underinclusive. As the maps show, SBC has identified CLEC fiber collocated in central offices in many of SBC's wire centers that have not been mapped by its vendor.[35] Nevertheless, while the data demonstrably understate the amount of special access demand accessible by CLEC fiber, they are the best available, given that the Commission has never required CLECs to submit data regarding their deployment of alternative facilities. It is

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34 Casto Decl. Table 1.

35 *Id.* ¶ 14 n.12.

clear, however, that if CLECs were required to submit their own data, those data would show significantly greater facilities deployment.[36]

The widespread proximity of SBC's DSn-level customers to competitive fiber underscores the immense scope of potential entry. Competing providers could bridge the 1000-foot gap to these customers at limited expense and could more than offset that expense with the resulting revenues.[37] Such entry is likely to accelerate as the growth in broadband demand makes more and more wire centers economically attractive to wireline competitors.[38]

Collocation statistics further underscore the growth of special access competition throughout SBC's region. Not only are numbers of collocators increasing,[39] but the *use* of such arrangements is increasing, as illustrated by the fact that the number of special access cross-connects between collocation arrangements increased by **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** in the last three years alone.[40] In fact, today SBC has more competitors with cross-connects than with collocation arrangements, which indicates that competitors are in many cases leasing facilities from one

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36 The extent to which data available to SBC and its vendor undercount CLEC facilities deployment is confirmed by the discrepancy between the data gathered by GeoResults regarding the number of CLEC-lit buildings and the data CLECs have provided to AT&T regarding the number of buildings accessible by their facilities. *See* Letter from Gary L. Phillips, SBC Communications, Inc. and Lawrence J. Lafaro, AT&T Corp., to Marelene H. Dortch, Secretary, FCC, WC Docket Nos. 05-65, 05-75, filed May 17, 2005.

37 Casto Decl. ¶ 15.

38 *See* UNE Fact Report 2004 at I-13 -14.

39 See *id.* Appendix E at E-1 (showing percentage of collocation in BOC MSAs).

40 *See* Casto Decl. ¶ 25.

another to serve special access customers, and thus decreasing their reliance on SBC's special access service components (such as transport).[41]

In addition, competitors are increasingly collocating at non-ILEC "carrier hotels," from which they can typically gain access to one another's fiber-optic transmission networks. Such arrangements allow competitors to exploit the larger footprint of competitive transport networks and give them indirect access to any SBC central offices or tandem offices that are connected to those transport networks.[42] These arrangements are prevalent throughout SBC's service territory, where there are over **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** known carrier hotels.[43] Carrier hotels and other bypass arrangements indicate not only the pervasiveness of wireline special access competition, but also the extent to which the Commission's existing competitive trigger formula, which relies solely on collocation at ILEC central offices, undercounts the actual level of facilities-based competition.

Just as important as the growth of this intramodal competition is the accelerating pace of intermodal competition. As of last year, intermodal carriers already accounted for more than two-thirds of the residential and small-business broadband market,[44] and their influence in special access will increase dramatically in the coming years as cable and fixed wireless carriers continue to flex their technological muscle. As the Commission recently recognized, intermodal

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41 *Id.* ¶ 26.

42 *Id.* ¶ 28; UNE Fact Report 2004 at III-17.

43 *See* Casto Decl. ¶ 28.

44 UNE Fact Report 2004 at A-1.

alternatives "are currently being used, and will likely increasingly be used, to provide loop substitutes to support services that compete with incumbent local services."[45]

The most established intermodal carriers are cable operators, whose near-ubiquitous high-speed networks currently allow them to deploy special access services inexpensively at the DS1 and DS3 levels as well as at faster speeds. Cable is already a major player in the market for voice and data services; as the D.C. Circuit has noted, "[t]he Commission's own findings" confirm "the dominance of cable[] in the broadband market."[46] Using their existing facilities, cable providers today have access to an estimated market of over 20 million business lines,[47] and they are actively expanding their fiber-to-the-curb infrastructure to include business customers.[48] These facilities are an increasingly important source of special access competition for SBC. Cox Communications, which increased its access line penetration from 960,000 to 1.5 million voice grade equivalents in 2003 alone, now offers special access bandwidth from DS1 to OC192.[49] Comcast, with as many as 4 million small and medium-sized businesses within 200 feet of its fiber and coaxial infrastructure, targets organizations "with 1-100 employees"—in other words, the heart of the BOCs' DS1 and DS3 customer base.[50] Other cable companies are certain to follow as competition at all levels intensifies between such Multiple System Operators (MSOs) and the ILECs.

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45 *Triennial Review Order* at 17117-18 ¶ 228.

46 *United States Telecom Ass'n v. FCC*, 290 F.3d 415, 428 (D.C. Cir. 2002) ("*USTA I*"), *cert. denied sub nom. WorldCom, Inc. v. United States Telecom Ass'n*, 538 U.S. 940 (2003).

47 Casto Decl. ¶ 37.

48 UNE Fact Report 2004 at III-25.

49 Casto Decl. ¶ 39.

50 UNE Fact Report 2004 at III-38, Casto Decl. ¶ 41.

And SBC has firsthand experience of the competitive threat posed by cable in the special access market: cable operators have won the business of many former SBC customers. Indeed, Mr. Casto reports that **[BEGIN CONFIDENTIAL INFORMATION]** **[END CONFIDENTIAL INFORMATION]** of SBC's retail DS1 customer losses are to cable providers.[51] Pricing pressure in the DS1 and DS3 market segments will continue to intensify as cable providers add facilities and, in Time-Warner's words, "go more aggressively after the enterprise business."[52]

While this evidence shows that cable companies are already winning special access customers in significant and increasing numbers from traditional wireline providers, leading indicators further suggest that the next generation of fixed wireless providers, including providers of WiMAX services, pose an even greater competitive threat. In the last several years, large-scale fixed wireless communications networks have shifted from trade-show hype to marketplace reality. At least nine fixed wireless providers are now offering DS1- and DS3-equivalent services in almost 75 MSAs.[53] For example, the provider TowerStream is aggressively marketing its service as a substitute for traditional wireline special access services, offering transmission speeds up to 1000 Mbps over its fixed wireless network to enterprise customers from Chicago to Los Angeles.[54] First Avenue Networks offers mobile backhaul and

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51 Casto Decl. ¶ 43.

52 UNE Fact Report 2004 at III-38 and Appendix H (quoting Time-Warner corporate materials).

53 UNE Fact Report 2004 at III-20-21.

54 Casto Decl ¶ 50.

other high-capacity services over its wireless network at speeds ranging from T-1 (1.5 Mbps) to OC12.[55]

Fixed wireless providers couple their technological advantages with low up-front costs. For example, DS1-equivalent service can be provisioned over fixed wireless technology in 24 to 48 hours—far less than the time and cost incurred in traditional wireline deployment.[56] The 2003 publication of the WiMAX standard, which provides for faster wireless signals over distances up to 30 miles without any line-of-sight requirement, has banished any remaining uncertainty regarding the future of fixed wireless.[57] And investors and entrepreneurs are lining up: Intel and Nokia have joined to pursue WiMAX development aggressively,[58] manufacturers are rushing new wireless hardware to market, and companies such as NextWeb and TowerStream are erecting towers in SBC's most lucrative markets.[59] Even BellSouth has announced that it will use WiMAX protocols to deploy broadband service to customers in its service area.[60]

The geographic range of WiMAX, coupled with transmission speeds at the DS3 level and higher, belie any claim that the BOCs face no competition in end-user channel termination services in Tier II and III MSAs. Not only can new fixed wireless carriers like TowerStream enter these markets, but existing carriers—including cable providers and CLECs—can use

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55 *Id.* ¶ 48.

56 Casto Decl. ¶ 45.

57 *See* UNE Fact Report 2004 at III-20.

58 *Id.* at A-11.

59 Casto Decl. ¶ 49-52.

60 BellSouth Trial pre-WiMAX Wireless Broadband (June 8, 2005), available at http://www.itvibe.com/news/3586.

transmission towers and leased or purchased spectrum to expand their fiber networks to serve customers that would otherwise be economically out of reach.[61] Indeed, the value of fixed wireless networking only increases in those markets where wireline deployment is most expensive, since the facilities costs per transmission mile are so much lower. Those high-cost wire centers that most concern the Commission, therefore, are the ones most susceptible to entry by fixed-wireless providers.

Though still in its early stages, this next generation of fixed wireless is already exerting significant competitive pressure on SBC across its entire operating area. For example, in three recent contract negotiations with large wholesale special access customers, the customers demanded, and paid for, "technology upgrade escape" clauses that would allow them to abrogate the remainder of their contract terms if certain alternative service technological thresholds are achieved.[62] These customers are thus confident enough in the development of cheaper alternative technologies—primarily fixed wireless—that they are willing to pay more now for the freedom to switch later. Although these sorts of marketplace shifts take time to show up in traditional market share data, they clearly show that, within the next several years, WiMAX and its heavily invested backers will establish fixed wireless as an everyday alternative to wireline special access services.

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61 UNE Fact Report 2004 at III-21; *see Triennial Review Order* at 17120 ¶ 232; Casto Decl. ¶ 46. Moreover, technologies like satellite and Broadband-over-Power-Lines, while still in development, may also discipline special access pricing in rural and suburban areas in the near future.

62 Casto Decl. ¶ 53.

B. SBC's Special Access Prices in Phase II MSAs Have Generally Decreased.

Since the Commission adopted its pricing flexibility rules, the average true price to the customer of SBC's special access services has dropped, not risen has some have alleged, and even base tariff rates in Phase II MSAs are generally no higher today, even in nominal terms, than they were in 2001 (when Phase II pricing flexibility was first implemented in SBC's territory).[63] This is true even at DS1 and DS3 bandwidths.[64] Internal SBC revenue numbers show declining average DSn prices across SBC's entire service area.[65] Overall, SBC's DS1 prices fell **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** and DS3 prices dropped **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** between 2000 and 2004.

The advocates of re-regulation support their contrary conclusions by relying almost exclusively on the base tariff special access prices (the "base tariff rates") offered by SBC in Phase II MSAs. But these base tariff rates do not remotely reflect the average price the customer actually pays. SBC offers a variety of substantial term and volume discounts to customers—including to the very CLECs that complain loudest about the base tariff rates in their regulatory advocacy—to encourage continued utilization of SBC's network. To avoid losing to competitors the large wholesale and enterprise customers who provide the bulk of its special access revenues, SBC also aggressively negotiates individual contracts to meet customer demands, generally including price discounts and other favorable terms to customers. As the Commission has noted, "contracts assure recovery of direct facility costs and allow amortization of up-front sunk costs

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63 *Id.* ¶ 58 & n.49.

64 *Id.* ¶ 56.

65 *Id.*

over the life of the transaction."[66] SBC has entered into scores (and pursued hundreds) of price-flex contract tariffs with individual customers—each one reducing the average price for special access and decreasing the cost of telecommunications service.[67] And when these targeted offers are accepted, they become available to similarly situated customers.[68] What's more, the tariff filings become available to allow other customers to know what "deals" might be available even if the tariff does not specifically apply.

This aggressive pricing competition is precisely the type of conduct one would expect in a competitive market. And it occurs not only in SBC's Tier I markets, but in Tier II and III MSAs as well, and for all bandwidths. In the Tier III MSA of Abilene, Texas, for example, the number of active special access competitors increased from **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** between 2001 and 2004, and the price of DS1 service accordingly declined by **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** during the same period.[69] These smaller markets may not have seen as much competitive entry as cities like San Francisco or Dallas, but customers in places like Abilene have clearly benefited from pricing flexibility as well.

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66 *Notice* at 2032 ¶ 118.

67 *See* Casto Decl. ¶ 65.

68 SBC's negotiated contract offers are often *not* accepted. For example, SBC proposed to provide a customer 1,600 DS1s and 57 DS3s in Dallas, Houston, San Antonio, and Austin at approximately **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** off the tariffed 60-month rates, yet lost the bid to another provider. *See* Casto Decl. ¶ 66.

69 *See id.* ¶ 22 (citing data SBC collected via an independent consultant).

In addition to their inappropriate reliance on base tariff rates, the advocates of re-regulation further compare those rates not to appropriate rates for top-quality special access services—like those offered by the BOCs—in a competitive market, but rather to the BOCs' regulated price cap rates. That comparison is specious. These regulated rates are the product of (i) price caps initially determined, a decade and a half ago, under rate-of-return regulation, and (ii) various ensuing X-factors. As explained in the attached declaration of Harvard political economy professor Joseph Kalt, there is no reason to believe that the BOCs' price cap rates are the right benchmark.[70] The Commission moved to pricing flexibility precisely because regulators are not omniscient and cannot precisely fix the rates that a fully competitive market would produce for the BOCs' premium special access services. It thus is entirely arbitrary to pick the price cap rates as somehow approximating the "right" rates for special access services. Indeed, to the extent the pace of competitive entry is slower in price cap MSAs than in pricing flexibility MSAs, one reason may be that rates in the former are materially *below* what would prevail in a free market (and thus discourage competitive entry). In short, the BOCs' price cap rates are an illegitimate benchmark for evaluating the BOCs' effective special access prices in price flex areas.

Finally, in the Commission's own judgment, the availability of UNEs as an alternative to special access services exerts significant downward pressure on the price of those services.[71] And, under the Commission's current rules, DS1 and DS3 UNEs that perform the same functions

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70 *See* Kalt Decl. ¶ 69.

71 *See* Order on Remand, *Unbundled Access to Network Elements, Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, WC Docket No. 04-313, CC Docket No. 01-338, FCC No. 04-290 ¶ 65 (rel. Feb. 4, 2005) ("*Triennial Review Remand Order*" or "*TRRO*").

as DS1 and DS3 special access services continue to be available in all but the most densely populated locales.[72]

C. Special Access "Rates of Return" Based on ARMIS Data Are Flawed

As discussed, the direct market evidence shows that special access competition is flourishing in many markets and increasing in all of them, and that the prices customers actually pay for special access services are declining. With nothing else to point to, the advocates of old-style price regulation thus resort to invoking ARMIS data for the proposition that the price cap LECs are earning excessive rates of return on their special access services and that, contrary to all the direct evidence, competition must therefore be failing. This argument is untenable. ARMIS data have never been an appropriate source for determining the real world costs or profitability of particular services. And such data have become particularly meaningless for those purposes during the five years in which the BOCs have had pricing flexibility, because during that period the factors used to make cost allocations for ARMIS reporting purposes have been frozen. In any event, as we show below, the ILECs' enterprise-wide rates of return have substantially *declined* since 1999. It is therefore both absurd and dangerous to suggest that specious rate-of-return calculations specific to special access illustrate a problem that the Commission should intervene to address.

1. As an initial matter, ARMIS data do not and cannot reflect the real-world economic allocation of costs to various services. ARMIS simply incorporates a rough mechanism for dividing multi-jurisdictional costs that are frequently shared and common into service-specific

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[72] *See Triennial Review Remand Order* ¶¶ 66, 126-30.

and jurisdictionally divided categories.[73] While ARMIS numbers might serve as a useful regulatory tool for some purposes, they do not provide a basis to assess how much it "costs" a BOC to provide any stand-alone service.[74] As a result, even apart from the five-year-old freeze discussed below, it would be entirely meaningless to compare the BOCs' special access *revenues* for a particular service—which *are* reported on a real-world basis in ARMIS—to the *costs* of that service as reflected in ARMIS.

Pursuant to the "jurisdictional separations" rules (first established in 1947 and revised in 1969 and 1987) underlying ARMIS, BOCs (among other ILECs) must apportion their plant investment and other costs to various categories set forth in Part 36, and then further separate these categories of costs into interstate and intrastate amounts. BOCs decide *how much*

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[73] *See, e.g.*, Declaration of John C. Klick and Michael R. Baranowski ("Klick & Baranowski Decl.") ¶ 27 (Tab D); Kalt Decl. ¶ 80-82; *see also* Declaration of Alfred E. Kahn and William E. Taylor on Behalf of BellSouth Corporation, Qwest Corporation, SBC Communications, Inc. and Verizon, filed in RM-10593 as an attachment to Opposition of SBC Communications Inc., Dec. 2, 2002, at 7-9 ("Kahn and Taylor Decl."). Because "interstate and intrastate services are largely provided over common facilities," the Commission has previously found "no evidence that there was an economically meaningful way to divide and measure the facilities used for the provision of interstate service from facilities used for provision of intrastate services." *See* Fourth Further Notice of Proposed Rulemaking, *Price Cap Performance Review for Local Exchange Carriers*, 10 FCC Rcd 13659, 13669 ¶ 63 (1995) ("*Fourth Further Price Cap NPRM*").

[74] Indeed, the Commission has recognized that the category-specific returns reported in ARMIS "do[] not serve a ratemaking purpose." Order on Reconsideration, *Policy and Rules Concerning Rates for Dominant Carriers*, 6 FCC Rcd 2637, 2730 ¶ 199 (1991); *see also Fourth Further Price Cap NPRM* at 13669 ¶ 63 ("[C]osts and demand that are 'separated' between the state and interstate jurisdictions pursuant to Part 36 of the Commission's Rules may not be optimal benchmarks for setting interstate rates"). And as discussed in SBC's previous comments in this proceeding, AT&T itself has expressly agreed that the challenges in accounting for shared, multi-jurisdictional facilities makes it nearly impossible to calculate the "cost" basis for a service that would allow calculation of an "economically meaningful rate of return[.]" *See* Kahn and Taylor Decl. at 8 (quoting Initial Brief of AT&T Communications of New England, Inc., filed in Mass. D.T.E. Docket DPU 97-79, Apr. 23, 1992, at 42-43).

investment to apportion, both categorically and jurisdictionally, based on "factors."[75] Before 2001, those factors reflected the results of periodic, extensive studies of how the investment was deployed.[76] Expenses, such as overhead, also must be divvied up, based on complex formulas derived in part from these factors.[77] The interstate portions of all of these separated (regulated) costs must then be apportioned among interexchange services and rate elements—such as special access, common carrier line, or traffic sensitive (including switched access)—under Part 69 of the Commission's rules, and reported as such in ARMIS. BOCs also report their *revenues* associated with the ARMIS service and rate elements.[78]

The shelf life of *any* set of separations/allocation rules is necessarily limited because, in the real world, proper cost-allocation is fluid. Technological, market, and even legislative changes can affect the ways in which a carrier uses plant, shifting the real-world "economic" allocation of costs toward one service or jurisdiction and away from another far more quickly than regulators can track or allocation studies can measure. As the pace of change in the communications industry began to accelerate rapidly following passage of the 1996 Act, this problem was seriously exacerbated. Thus, as early as 1997, the Commission acknowledged the need for a "comprehensive review" of the Part 36 separation rules (including categories) to assess whether they were working as intended.[79] And by May 2001, the Commission had

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75 *See* Toti Decl. ¶¶ 6-8.

76 *See id.* ¶ 15.

77 *See id.* ¶ 10.

78 *See id.* ¶¶ 9, 11.

79 *See* Notice of Proposed Rulemaking, *Jurisdictional Separations Reform and Referral to the Federal-State Joint Board*, 12 FCC Rcd 22120, 22126 ¶ 9 (1997) ("*Separations NPRM*"). In initiating this review, the Commission observed that the telephone network had "changed substantially since the jurisdictional separations rules were first established in 1947," *id.* at

concluded that the ARMIS accounting rules were "outdated regulatory mechanisms that are out of step with today's rapidly-evolving telecommunications marketplace."[80]

2. The intervening years have now completely eradicated any remaining relationship between the real world "costs" of specific services and the costs as reflected in ARMIS. When it recognized that ARMIS rules were already unmoored from the realities of the industry in 2001, the Commission decided to freeze the categorical and jurisdictional separations factors for ARMIS at their 2000 levels, at least pending comprehensive reform of the Part 36 rules.[81] For obvious reasons, the freeze has greatly exacerbated the inherent inaccuracy of the cost results reported in ARMIS. Before the freeze, the BOCs performed periodic studies designed to measure patterns of plant usage, which would then serve as a basis for allocating more or less investment to one Part 36 category or another.[82] But since the freeze, the BOCs must allocate

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22128 ¶ 12, and that "[t]he introduction of new network control technologies changes the way services are delivered and thus calls into question the validity of service distinctions specified in the separations rules," *id.* at 22128 ¶ 13. The Commission further noted that "the growth in the number of services offered, often using the same facilities, makes an increasingly larger share of telecommunications joint or common," thereby "suggest[ing] that separations procedures may need to place increased emphasis on the allocation of joint or common costs." *Id.* at 22130 ¶ 16.

80 *See* Report and Order, *Jurisdictional Separations and Referral to the Federal-State Joint Board*, 16 FCC Rcd 11382, 11383 ¶ 1 (2001) ("*Freeze Order*"). The Commission worried that, even in the years since it issued its 1997 *Separations NPRM*, "rapid changes in the telecommunication infrastructure," including growth of the Internet and increased usage of packet switching, could "produce cost shifts in separations results because these and other new technologies . . . as well as a competitive local exchange marketplace, *are not sufficiently contemplated by the current Part 36 rules.*" *Id.* at 11389-90 ¶ 12 (emphasis added).

81 *See Freeze Order* at 11383 ¶ 2. The Commission's *Freeze Order* made eminent sense, given the fact that the Commission had de-emphasized cost-based price regulation over the prior eleven years, and, therefore, the outdated separations rules were of greatly diminished importance.

82 *See* Toti Decl. ¶ 15.

approximately the same percentages of investment to the same categories regardless of changes in usage patterns based on technological change or market trends.[83]

A simplified example illustrates the problem. Assume that a certain type of plant was shared between two interstate access services in 2000, and—as a result of the separations process—was allocated 50/50 between those two services. In 2005, the BOCs must still allocate that plant investment 50/50 between those two services—even if as a real-world matter, one of the two services has fallen dramatically in popularity (because of technological bypass, for example), and thus the overwhelming majority of such investment is in fact directed to the other service. Similarly, if the BOC invested in new facilities to serve *only* the more popular service, it would nevertheless have to allocate the costs of those facilities equally between the two services. Comparing the 2005 real-world revenues from the popular service to the 2005 ARMIS reported *costs* would therefore produce a completely meaningless rate of return, because the allocation of real-world costs would be dramatically understated.

That is precisely the problem with using ARMIS data to make relevant conclusions about the BOCs' rate of return for interstate special access services since pricing flexibility has been in effect. The ILECs' interstate special access volumes have steadily increased,[84] while the percentage of ILEC *interstate* services generally (*e.g.*, packet switched) has also been growing.[85]

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83 *See id.*; *see also* Klick & Baranowski Decl. ¶¶ 27-28.

84 *See Notice* at 2005-06 ¶¶ 27-28.

85 *See Freeze Order* at 11389-90 ¶ 12; *compare* Federal-State Joint Board on Universal Service, *Universal Service Monitoring Report*, CC Docket No. 98-202, at 11-28 tbl. 11.7 (Oct. 12, 2004), *available at* http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/Monitor/mr04-0.pdf (noting that interstate services constituted 32.28 percent of the BOCs' total operating revenues in 2003) *with* Federal-State Joint Board on Universal Service, *Universal Service Monitoring* Report, CC Docket No. 98-202, at 11-15 tbl. 11.7 (Nov. 9, 2000), *available at* http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-

Yet pursuant to the *Freeze Order*, the BOCs have been unable to allocate any of the additional investment and expenses *actually used* for interstate special access services to the ARMIS-reported special access element.[86] The result is complete mismatch between these severely underreported costs and the accurately reported revenues for these services. The "special access" rate of return figure that can be calculated from ARMIS is thus meaningless.[87]

Available volumes data for all of the BOCs make it clear that the freeze has produced systematic underreporting of investment and expense related to special access. Over the past five years, the number of special access lines has grown significantly as demand has exploded for sophisticated data services. Between 1999 and 2004, the number of SBC's special access

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State_Link/Monitor/mrs00-0.pdf (noting that interstate services constituted 26.73 percent of the BOCs' total operating revenues in 1999).

[86] *See* Toti Decl. ¶¶ 15, 17; *see also Freeze Order* at 11389-90 ¶ 12 & n.31 (explaining that, under normal operation of the separations rules, "[i]ncreasing investment in specific categories (*e.g.*, interexchange cable and wire facilities (C&WF) may . . . contribute to jurisdictional shifts in the final results," and "changes in customer calling patterns (*e.g.*, increased interstate calling) will cause shifts in the jurisdictional allocation factors").

[87] *See* Toti Decl. ¶¶ 4-5, 17-18. The freeze's impact on the allocation of costs of central office equipment ("Circuit Equipment"), a type of plant equipment used for both special access and switched access services, is but one example of how the freeze has greatly distorted cost results reported in ARMIS. Based on factors obtained through studies conducted before 2001 -- but still applied by ILECs today—SBC can apportion no more than approximately 35% of all Circuit Equipment investment to Part 36 categories known as "wideband" and "private lines," which encompass facilities used for special access, and no more than approximately 20% to the interstate components of these categories. This 20% portion then gets assigned to the special access element under Part 69. *See id.* ¶¶ 29-32; *see* 47 C.F.R. Part 36 Appendix, Glossary (defining "wideband"); *Separations NPRM* at 22147-48 ¶ 57. Meanwhile, SBC must allocate 65% of Circuit Equipment investment to other Part 36 categories, such as "message" and "joint use," which encompass facilities used for common line and traffic sensitive services. These investment allocations, in turn, drive the allocations of other costs, such as plant specific expenses and common overhead, among the same ARMIS reported services and elements. *See* Toti Decl. ¶ 10. SBC has been required to make these percentage cost allocations since 2001, even though *actual* investment in circuit equipment and related expenditures for interstate special access purposes very likely grew to much higher proportions, compared to costs incurred for common line and traffic sensitive services, or intrastate services. *See id.* ¶¶ 18-20.

lines grew 127% (cumulatively). The BOCs combined saw their special access lines increase nearly 150% over the same period. Meanwhile, during the same period, whether because of competition or technological bypass and other advances, the number of SBC's switched access lines decreased 23% (cumulatively), and the BOCs combined saw their switched access lines decrease 21%.[88] As one would expect, the BOCs' revenues for these different types of services have followed similar trends. By 2004, the BOCs' combined interstate special access revenues had increased approximately 100% since 1999, while the combined interstate carrier common line and traffic sensitive revenues had decreased by 24% over this same time period.[89]

Because customers are requesting relatively much *more* special access within the mix of telecommunications services, it is reasonable to assume that carriers are allocating a higher proportion of their investment and expenses to supporting these new services—and away from switched access.[90] It would make no sense for the BOCs to have continued directing as much investment into stagnant (or dwindling) switched access services. The only rational conclusion is that a real-world allocation of special versus switched access investment and costs would require a demand-based readjustment, increasing the percentages of investment and expenses allocated to special access services. The frozen separations factors underlying ARMIS data prevent this reallocation, producing skewed, unrealistic, and therefore ultimately useless results.[91]

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88 *See id.* ¶ 18.

89 *See id.* ¶ 19.

90 *See id.* ¶ 20.

91 *See id.* ¶ 20.

A review of historical ARMIS cost allocation data for all BOCs confirms this conclusion. From 1995 through 2000, the percentages of Circuit Equipment and Cable and Wire Facilities investment (the two types of investment most relevant to special access[92]) and total plant investments allocated to the interstate special access element increased commensurately with the growth in interstate special access revenues as a percentage of total revenues subject to separations. Starting in 2001, however, after the separations factors were frozen, interstate special access revenues as a percentage of total *revenues* subject to separations continued to grow (increasing from 9.5% in 2000 to 16% in 2004), but the percentages of *investment* allocated to interstate special access for each of the plant accounts *flattened out* during the same period.[93] Historically, then, right up until the freeze in 2001, the growth of the percentage allocation of total plant investment to special access followed a similar pattern to the growth of the percentage of total revenues comprised of special access.[94] The fact that this trend changed immediately after the freeze strongly suggests that the change was an artificial byproduct of the freeze, not the result of a sudden and unexplained increase in special access productivity.[95]

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92 In 2004, for all BOCs combined, Circuit Equipment and Cable and Wire Facilities made up 89% of the total plant investment apportioned to interstate special access. *See id.* ¶ 22.

93 *See id.* ¶ 23. In the *Freeze Order*, the Commission decided to set calendar year 2000 as the base year of the freeze, and not the twelve-month period immediately preceding the release of its *Order*. *See Freeze Order* at 11396 ¶ 27. As shown in Attachment 2 to Mr. Toti's declaration, the first year in which the percentage allocation of special access revenues grew significantly faster than the percentage allocation of special access investment was 2001, the first year (after 2000) that ILECs used the frozen factors. Toti Decl., Attach. 2.

94 *See id.* ¶ 24.

95 *See id.* And because, since 2001, the percentage of special access-related investment ceased to keep pace with special access revenues as a percentage of total revenues subject to separations, so too did the reported percentage of *support* costs related to special access start to lag significantly in that year. It follows that support-type costs (like investment costs) were under-reported to the special access element starting in 2001, due to the freeze, causing

Because the Part 36 categories do not reflect how capital spending is tracked, it is difficult to measure precisely the impact of the freeze on its calculated special access returns. Nonetheless, information about SBC's Circuit Equipment investment alone is illustrative. While that investment grew $6.5 billion from 2000 to 2004, SBC, as a result of the freeze, apportioned only $1.7 billion of this growth to the Part 36 "Wideband" category—the interstate component of which is assigned entirely to special access.[96] If SBC could have increased allocation of the growth in Circuit Equipment investment to Wideband by 10%—a percentage that appears to be extremely conservative in light of the rapid growth in special access lines over this time—this would have yielded an additional $455 million of additional interstate special access investment.[97] If one (quite plausibly) assumed that as much as 50% of the growth in Circuit Equipment since 2000 should have been allocated to Wideband, that would have produced more than $1.1 billion in additional interstate special access investment for SBC.[98] Even this reallocation, standing alone—which does not encompass other types of investment (*e.g.*, Cable and Wire Facilities, the Circuit Equipment private line categories) or costs (*e.g.*, plant specific expenses and overhead)—would substantially alter the special access rate of return calculated under ARMIS. And this, of course, is only one of the many recalculations that would be necessary to begin bringing the ARMIS data anywhere close to "real" economic cost allocation.

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calculations of rates of return for special access based on frozen allocators to be further overstated. *See id.* ¶¶ 25-28.

96 *See id.* ¶ 34.

97 *See id.* $455 million would have represented the interstate portion of the additional $650 million in circuit equipment investment allocated to wideband. This example assumes no change in the jurisdictional allocation of wideband. *See id.*

98 *See id.*

The *Notice* appears to minimize concerns about the reliability of accounting rates of return derived from ARMIS data, stating that "we use ARMIS data for the limited purpose of examining the relationship between demand growth and growth in expenses and investment. To the extent the accounting rules have remained the same over the period analyzed, the analysis of growth rates and scale economies should not be significantly affected by the cost allocation issues these parties raise."[99] This makes no sense. As the Commission itself suggested in the *Separations NPRM* and *Freeze Order,* legislative, technological, and market changes have seriously undermined the legitimacy of ARMIS data for any such purpose.[100] In particular, if ARMIS-reported cost data are unreliable, so too are the rates of return derived from those data. And, as discussed above, one reason that ARMIS-reported cost data are unreliable today, and why comparisons over the relevant time period cannot be made, is precisely because "the accounting rules have remained the same."

3. Finally, even if ARMIS data *could* be used to derive service-specific rate-of-return numbers, the 11.25% rate of return the Commission proposes as a "benchmark" for evaluating whether special access rates are "just and reasonable" is completely indefensible.[101] As the *Notice* observes, that benchmark was established in 1991[102] and was based on data that preceded even that year. It is untenable to suggest that an increasingly competitive market today would price ILEC offerings to produce an 11.25% return on invested capital either for special access services specifically or for telecommunications services more generally.

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99 *Notice* at 2006 ¶ 29.

100 *See Freeze Order* at 11383-84 ¶¶ 1-2, 12; *Separations NPRM* at 22126-31 ¶¶ 9-19.

101 *Notice* at 2014 ¶ 60.

102 *Id.*

The special access market is radically more competitive than it was in 1991. Even if the 11.25% figure represented a reasonable return for special access services in 1991 (and, as discussed below, it was never designed as a service-specific return even in 1991), the ILECs faced comparatively little risk in the special access market at that time. By 1990, CAPs had deployed only 20 networks in 15 cities.[103] Even by 1995, ILECs were facing special access competition from only 29 fiber-optic network providers in only 104 cities.[104] While the seeds of competition had been sown, they have now borne fruit far beyond original expectations. Over the past decade, special access competition from both intra- and intermodal competitors has exploded in scope, and this growth shows every sign of continuing. Indeed, as noted above, new technologies like WiMAX and cable now present serious additional sources of competition in the special access markets. All of these competitive pressures subject the ILEC special access business to much greater risk than before.

With these risks comes a considerably higher cost of capital. It would be entirely arbitrary to assign a last-generation 11.25% rate of return as the benchmark for assessing "appropriate" ILEC returns. Accordingly, if the Commission reverses a decade of incentive-based pricing and reverts to rate-of-return regulation through the guise of "re-initializing" price caps, it would need to set a significantly higher rate of return for special access services—a rate that takes full account of the extensive competition in the special access market, including from intermodal competitors that increasingly bypass the ILECs' networks entirely.

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103 U.S. Department of Commerce, *U.S. Industrial Outlook* at 33-37 (1990).

104 UNE Fact Report, filed in CC Docket No. 96-98, as an attachment to the Comments of the United States Telephone Association, May 26, 1999, at II-3 (citations omitted).

Moreover, the 11.25% "benchmark" to which the *Notice* refers was an enterprise-wide rate of return that took into account both the ILECs' highly competitive services and their less competitive services.[105] It assumed the ILECs would earn high revenues in some areas to compensate for lower revenues in others and would thus earn a *total* rate of return of 11.25%. The Commission cannot now reasonably impose that same 11.25% rate of return as a *cap* on ILECs' competitive special access services while leaving in place the ILECs' obligation to continue providing other services, such as switched access, at much lower—in some cases negative—rates of return. Doing so would produce an *overall* rate of return far lower than the 11.25% enterprise-wide figure—a result no one could seriously try to defend.

Indeed, if the ARMIS data show anything of use at all, they suggest that at the *enterprise* level, the BOCs are not experiencing "excessive" overearnings. The BOCs' combined, enterprise-wide rate of return for regulated services dropped from approximately 16% in 1999 to 13% in 2004.[106] The Commission may not simply slash the ILECs' rate of return for special access rates in isolation to 11.25% (or any other level) without considering how this will affect the companies as a whole. As carriers of last resort, ILECs have always been party to a regulatory compact under which they endure some below-cost rates in return for revenue opportunities from higher-priced services. And even the framework established in the *Pricing Flexibility* and *CALLS Orders* was designed as a comprehensive package involving a trade-off in pricing between special and switched access services.[107]

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105 *See* Kalt Decl. ¶ 73.

106 *See* Toti Decl. ¶ 39.

107 For example, a carrier that qualified for and elected to exercise pricing flexibility for any special access services in any MSA was required to give up the right to a low end adjustment for all services (including switched access) at the holding company level, and thus throughout its

In short, any positive return the ILECs may earn on their special access services is more than swallowed up by losses the ILECs are forced to sustain on other services in order to achieve public interest goals such as low rates for basic local service. The BOCs' combined intrastate rate of return fell from 15% in 1999 to approximately 9% in 2004, and their combined return for total interstate traffic-sensitive services fell from 27% in 1999 to 2% in 2004.[108] SBC's rate of return for such switched services was *negative* over the past three years, based on ARMIS data.[109] This should be sufficient to show the fundamental unfairness of an effort to fix a rate of return for special access in isolation from adjustments to the ILECs' other rates. In particular, the Commission cannot simply reduce "high" special access rates unless it allows the ILECs to raise their switched access rates above their depressed levels under CALLS.[110]

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entire service territory, irrespective of its rate of return for switched access services. *See Pricing Flexibility Order*, 14 FCC Rcd at 14304 ¶ 162.

108 *See* Toti Decl. ¶¶ 39, 40.

109 *Id.* ¶ 40.

110 In fact, the Commission has repeatedly recognized that where it reduces revenues on which the BOCs have traditionally relied for implicit support for other services, it must make corresponding adjustments to avoid confiscatory results that would undermine that implicit support. *See, e.g.*, Notice of Proposed Rulemaking, *Developing a Unified Intercarrier Compensation Regime*, 16 FCC Rcd 9610, 9654-55 ¶ 124 (2001) (recognizing the need to study "how any new intercarrier compensation regime . . . will impact the collection of universal service contributions"); *CALLS Order* at 13039 ¶ 185 (recognizing the obligation to "provide explicit support to replace the implicit universal service support in *interstate* access charges" if such charges are reduced); First Report and Order, *Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Transport Rate Structure and Pricing End User Common Line Charges*, 12 FCC Rcd 15982, 16142 ¶ 367 (1997). *See also* Seventh Report & Order and Thirteenth Order on Reconsideration in CC Docket No. 96-45, Fourth Report & Order in CC Docket No. 96-262 and Further Notice of Proposed Rulemaking, *Federal-State Joint Board on Universal Service; Access Charge Reform*, 14 FCC Rcd 8078, 8138 ¶ 128 (1999) ("Because of the role access charges have played in supporting universal service, it is critical to implement changes in the interstate access charge system together with the complementary changes in the federal universal service support mechanism . . . ."); *CALLS Order* at 12973 ¶ 25; *see also generally id.* at 12991-13007 ¶¶ 76-112 (raising SLC cap to compensate for decrease in access charges and other end-user charges).

The Commission suggests the complete opposite: that it is considering *reducing* special access rates to the level of comparable switched access rates.[111] That proposal is particularly indefensible. The Commission cannot compel reductions in switched access rates, outside of any measure of cost, and then point to them as an economically "just and reasonable" basis for setting special access rates. The *Notice* observes in passing that doing so might be "circular."[112] In fact, it would be grossly arbitrary. Further, if the Commission truly believes that 11.25% is a relevant benchmark, the evidence set forth above indicates that the switched access rates and the return the BOCs earn from them are substantially too *low*—yet another factor that would make such rates a patently unreasonable basis for establishing special access rates.

II. The Supposed "Fixes" Proposed in the Notice Would Do Far More Harm than Good

Although all the evidence conclusively demonstrates that the special access market is operating at it should, the *Notice* nevertheless considers several highly regulatory "modifications" to the Commission's current regime. These include elimination of Phase II pricing flexibility, combined with a "re-initialization" of special access base rates and the imposition of a new productivity adjustment or "X-factor." These proposals lack any sound basis and should be rejected.

A. Re-initialization Would Undermine Fifteen Years of Incentive-Based Pricing

Price cap regulation is designed to "encourage[] incumbent LECs to improve their efficiency by harnessing profit-making incentives to reduce costs, invest efficiently in new plant and facilities, and develop and deploy innovative service offerings, while setting price ceilings at

111 *Notice* at 2017 ¶ 66.

112 *Id.*

reasonable levels."[113] Precisely as the Commission intended, the ILECs have pursued productivity gains in providing special access services in whatever way they could, naturally believing that the Commission's rejection of rate-of-return regulation and its specific rejection of sharing meant that they would profit from any such gains. Now the advocates of re-regulation ask the Commission to breach its regulatory trust with the ILECs solely to provide a wealth transfer from those ILECs to purchasers of special access. As discussed in Part I(C), the premise of this proposal—that ILECs are earning excessive rates of return—is wrong. But even leaving that false premise aside, the proposal makes no policy sense on its face.

The *Notice* itself voices appropriate concern that a LEC's efficiency incentives under price cap regulation depend greatly on its "expectations of future regulatory action" and could therefore be undermined by any Commission action taken to "reallocat[e] benefits resulting from LEC efforts to minimize costs and innovate under the existing price cap plan."[114] That is an understatement. An ostensible "price cap" regime punctuated by re-initialization to reflect "acceptable" rates of return is just rate-of-return regulation by another name. Such a regime would defeat the very purpose of price cap regulation, to which the Commission has dedicated itself for 15 years: allowing firms to reap the benefits of their efficiency gains to give them appropriate incentives to pursue those gains in the first place. As Professor Kalt explains, providers would lose incentives to cut costs and innovate in this and other markets if the Commission shows a propensity, in this proceeding, to intervene in the market after committing itself to a policy of non-intervention.[115] That would be the precise outcome the Commission

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113 *Id.* at 1998 ¶ 11.

114 *Id.* at 2017 ¶ 67.

115 Kalt Decl. ¶ 70.

sought to avoid when it adopted a price cap regime, and an outcome wholly out of step with the 1996 Act.[116]

In any event, there is no sound policy basis for the government to intervene in the market solely to impose what it views as an "appropriate" rate of return. As the Commission recognized in the *Pricing Flexibility Order*, if ILECs with Phase II pricing flexibility price special access services high enough to generate outsized returns, "competitors will enter the market. . . . [and] provide additional supply of special access services at (presumably) lower prices than the incumbent."[117] If special access services offer better risk-adjusted returns than other investments, capital will flow to special access providers, increasing competition and pushing down margins. The market thus can self-adjust for excessive rates of return. On the other hand, if the Commission intervenes in competitive markets and sets rates too *low*, it would send false pricing signals to new entrants, deterring economically efficient entry in favor of inefficient

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116 As the Commission itself noted almost a decade ago, sharing—which is essentially no different from "re-initialization" to address supposed over-earning—is "a serious impediment to deregulation." Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262, *Price Cap Performance Review for Local Exchange Carriers; Access Charge Reform*, 12 FCC Rcd 16642, 16701 ¶ 151 (1997) ("*Fourth Price Cap Performance Review Order*"); *see also* Order on Reconsideration, *Price Cap Performance Review for Local Exchange Carriers*, 14 FCC Rcd 1684, 1688 ¶ 6 (1999) (sharing "was inconsistent with the general competitive paradigm that was established by the Telecommunications Act of 1996"). Similarly, the Interstate Commerce Commission recognized over two decades ago that it "would be reluctant to reduce existing rates on captive coal traffic if the source of an increased rate of return is increased efficiency in operations or a more profitable rate on competitive traffic" because "[t]o do so could serve as a disincentive to the carrier initiatives which led to the efficiencies or profit maximizations." Decision, *Coal Rate Guidelines Nationwide*, I.C.C. Ex Parte No. 347 (Sub-No. 1) (Feb. 8, 1983) at 16.

117 *Notice* at 2021 ¶ 79 (citing *Pricing Flexibility Order* at 14297-98 ¶ 144).

overuse of the ILECs' artificially underpriced special access services.[118] In the long run, no one, including special access customers, benefits from such an outcome.

B. The Commission Should Not Impose an X-Factor on ILEC Special Access Rates.

For similar reasons, the Commission should reject proposals to reimpose a productivity based "X-factor" on special access price cap rates.

1. First, there is no reliable basis for concluding that a productivity adjustment is or will be warranted for the ILECs' special access services. A productivity factor is by no means a mandatory component of a price cap regime. It is appropriate only insofar as there is some reason to expect that the productivity of the regulated company or service will exceed that of the economy as a whole.[119] Indeed, courts have expressly approved price cap regimes that do *not* include productivity factors, particularly where the record lacks evidence that the regulated entity or service will experience particular productivity gains.[120] But there is *no* basis to assume that the ILECs are or will be more productive than the economy as a whole. Indeed, as noted above, the BOCs' overall (both interstate and intrastate) regulated rate of return *declined* from approximately 16% in 1999 to 13% in 2004.[121] And LEC productivity is almost certainly

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118 Kalt Decl. ¶ 19.

119 *See* Klick & Baranowski Decl. ¶ 11.

120 *See, e.g., Association of Oil Pipe Lines v. FERC*, 83 F.3d 1424, 1431 (D.C. Cir. 1996) (upholding failure to apply productivity factor given "no evidence in the record of productivity gains for oil pipelines"); *Time Warner Entm't Co. v. FCC*, 56 F.3d 151, 173 (D.C. Cir. 1995) (in establishing a price cap for cable companies, FCC reasonably declined to include offsets for productivity gains, for which there was "no . . . evidence . . . in the present record"); *Association of Oil Pipe Lines v. FERC*, 281 F.3d 239, 247 (D.C. Cir. 2002) (refusing to require FERC to impose a price adjustment to reflect oil pipelines' productivity gains). *See also* Klick & Baranowski Decl. ¶¶ 16-17.

121 *See* Toti Decl. ¶ 39.

lagging behind that of much of the rest of the telecommunications industry, especially new low-cost entrants like VoIP providers.[122] Indeed, LECs will need to undergo consolidations and make significant investments in new technologies (such as the Project Lightspeed initiative that SBC has announced) simply to avoid losing ground to cable and other new competitors.[123]

In any event, even if one believed that LEC productivity overall *is* likely to improve at a faster rate than productivity economy-wide, that still would provide no basis for concluding that the productivity of the ILECs' *special access services* will itself improve.[124] As the Commission has recognized, different services within the same enterprise may exhibit different levels of productivity.[125] For example, when a company shifts the services it provides, it may experience major productivity improvements overall without any change in the productivity of a particular service.[126] Thus, an ILEC's overall productivity might hypothetically improve because it is offering more wireless service and less switched access, but that productivity improvement would signal nothing whatsoever about the productivity of its *special access* services.[127]

Indeed, certain ILEC special access services—the lower-capacity services, which are the only ones that even arguably should remain subject to price caps in some areas—may well exhibit no significant productivity enhancements, and certainly will not exhibit such enhancements to the same degree as other ILEC services. For example, most of SBC's DS1

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122 *See* Klick & Baranowski Decl. ¶ 18.

123 *See id.* ¶ 18 & n.20.

124 *See id.* ¶ 19.

125 *See Fourth Price Cap Performance Review Order* at 16664-65 ¶ 48 (citing *Railroad Cost Recovery Procedures – Productivity Adjustment*, ICC Ex Parte No. 290 (Sub-No. 4), 5 ICC 2d 434, 462 (1989), *aff'd sub nom. Edison Elec. Inst. v. ICC*, 969 F.2d 1221 (D.C. Cir. 1992)).

126 *See* Klick & Baranowski Decl. ¶ 19 n.22.

127 *See id.*

channel terminations are provided by means of older, copper-based technologies, which are not likely to experience the productivity gains of fiber-based or wireless services.[128] Nor is it even clear that higher-capacity special access services—which, as discussed below, ought to be removed from price caps altogether—will experience significant productivity gains in the future that outpace those in the overall economy, now that price-cap LECs have spent the past 15 years aggressively pursuing efficiencies under the price cap regime.[129]

In short, there is no need for a productivity adjustment in this market. So long as the Commission broadly grants downward (Phase I) pricing flexibility to the ILECs nationwide, prices will reflect competitive pressures and actual productivity improvements. They will certainly reflect market conditions more accurately and efficiently than a factor prescribed in a lengthy regulatory proceeding.[130] And, at worst, an ILEC's failure to reduce prices to reflect any real productivity improvements would create new opportunities for competitive entry.[131]

Finally, any aggressive productivity adjustment that forces special access rates *below* their real-world economic costs would be pernicious as well as unnecessary, because it would send false economic signals to the market and deter new entry.[132] As illustrated above, even in markets still subject to price caps, both intermodal and intramodal competition is rapidly developing. For example, while pricing flexibility is least common for DSn-level end user channel terminations, cable companies and fixed wireless providers stand ready to capture

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128 *See* Kalt Decl. ¶¶ 73-74; Klick & Baranowski Decl. ¶ 20.

129 *See* Kalt Decl. ¶ 74.

130 *See* Klick & Baranowski Decl. ¶ 21.

131 Such entry is now occurring even at the DS3 and DS1 levels. *See* Casto Decl. ¶ 7; Klick & Baranowski Decl. ¶ 22.

132 *See* Klick & Baranowski Decl. ¶¶ 18 n.21, 23.

market share for those services throughout SBC's region and nationwide. If the Commission artificially depresses the ILECs' special access rates through application of an aggressive, predictive, and unfounded productivity adjustment, it will depress the investment incentives of these new competitors to the detriment of all consumers.[133]

2. *In any event, developing an economically correct and relevant productivity factor* is a practically insurmountable challenge. Regulators have struggled with this challenge in various industries, because it is difficult to measure historical productivity and trends with any degree of accuracy, and even more difficult to make rational predictions about future productivity.[134] Even if past trends could be accurately identified, a regulator must establish some basis for predicting the degree to which *future* productivity gains will mirror *past* gains—a step that has drawn particularly skeptical judicial scrutiny in a variety of contexts.[135] Not surprisingly, then, the Commission has struggled with setting an accurate productivity factor for

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133 *See* Kalt Decl ¶ 19; Klick & Baranowski Decl. ¶¶ 18 n.21, 23.

134 *See* Klick & Baranowski Decl. ¶¶ 13-15.

135 *See id.* ¶ 14; *X-Factor Decision, supra*; *see also Association of Oil Pipe Lines*, 281 F.3d at 247 (describing efforts to forecast departures from historical trend as being characterized by "complexity and iffiness."); *Shell Oil Co. v. Federal Power Comm'n*, 520 F.2d 1061, 1078 (5th Cir. 1975) (noting "special problems [faced by] the Commission in using historical figures to predict future productivity"). Disputes about the ability to predict future productivity gains accurately also were, for this very reason, a central focus in UNE arbitrations before the FCC and state commissions. *See, e.g.*, Memorandum Opinion and Order, *Petition of WorldCom, Inc. Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia Inc., and for Expedited Arbitration*, 18 FCC Rcd 17722, 17776-781 ¶¶ 128-141 (2003) (discussing the parties conflicting positions on productivity gains); Opinion Establishing Revised Unbundled Network Element Rates for Pacific Bell Telephone Company d/b/a SBC California, *Joint Application of AT&T Communications of California, Inc. (U 5002 C) and WorldCom, Inc. for the Commission to Reexamine the Recurring Costs and Prices of Unbundled Switching in Its First Annual Review of Unbundled Network Element Costs Pursuant to Ordering Paragraph 11 of D.99-11-050*, Application 01-02-024, *Decision 04-09-063, at* 65-68 (Cal. Pub. Utils. Comm'n Oct. 1, 2004) (discussing differing productivity assumptions and cost model implementation).

years.[136] In 1999, the D.C. Circuit decisively rejected the Commission's most recent effort as arbitrary, specifically questioning the Commission's basis for measuring past productivity and its assumption that there would be a continuing trend of productivity improvements.[137]

For two reasons, the Commission would be even less able to calculate an economically viable productivity factor today. First, more than ever before, this industry is characterized by rapid change and uncertainty, which makes long-term "trend" predictions inherently suspect.[138] And any effort to set a productivity factor for special access services in particular—which, as noted above, is the only approach that could even possibly make economic sense[139]—would be doomed to failure, because the Commission has no reliable data upon which it could base such calculations. Productivity assessments have always been based on ARMIS, which is the most comprehensive set of publicly available data. As discussed in Part I(C), however, the service-specific cost allocations reported in ARMIS are inherently arbitrary. Indeed, in its original deliberations on price caps, the Commission explicitly rejected the suggestion that it establish a productivity factor specific to special access services, finding that the necessary calculations would be fundamentally flawed because they would rely on the inherently arbitrary cost

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136 *See Bell Atlantic Tel. Cos. v. FCC*, 79 F.3d 1195, 1198-1204 (D.C. Cir. 1996) (detailing history of FCC efforts).

137 *X-Factor Decision*, 188 F.3d at 525-26.

138 *See* Klick & Baranowski Decl. ¶ 14.

139 As explained above, there is no reason to assume that enterprise-wide productivity has any relevance to the productivity of a particular service. Accordingly, as the *Notice* appears to recognize, it would be indefensible to apply to special access rates an "X-factor" derived from enterprise-wide data. *See Notice* at 2009 ¶ 37; Klick & Baranowski Decl. ¶ 24. Indeed, following this logic still further, the most appropriate approach would be to conduct a productivity analysis for the different types of special access services, given their different competitive and pricing structures. *See id.* ¶ 26.

allocations in ARMIS.[140] And this problem has grown even more severe as a result of the 2001 cost-allocation freeze, which entirely divorces ARMIS cost data from reality.[141] Accordingly, such data provide no basis whatsoever to make meaningful assessments about the costs or productivity of special access services—either on a retrospective or prospective basis.

Thus, any factor the Commission picks is likely to prove wrong. And, in selecting that factor, the Commission would plunge the industry into years of litigation, just as it did in the pre-CALLS period,[142] deterring both investment and new market entry. For these reasons, imposing a productivity adjustment would harm special access customers more than help them. The Commission can achieve the procompetitive results it seeks far more effectively simply by giving LECs broad downward pricing flexibility, which will ensure that consumers receive the benefits of productivity and competition.[143]

3. For all these same reasons, the Commission should reject any proposal to adopt an "interim" factor of 5.3%.[144] As discussed, there is no empirical basis for the concern that such a

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140 *See* Fourth Further Notice of Proposed Rulemaking, *Price Cap Performance Review for Local Exchange Carriers*, 10 FCC Rcd 13659, 13670 ¶ 69 (1995).

141 *See* Klick & Baranowski Decl. ¶¶ 3, 28.

142 *See X-Factor Decision.*

143 *See* Klick & Baranowski Decl. ¶¶ 5, 21-22. Finally, the Commission could not readopt *downward* productivity adjustments for special access services without putting into place —*i.e.*, a low-end adjustment—safeguards to ensure that the LECs' special access prices are not driven below cost. This, however, signals a return to an increasingly complex and pervasive regulatory framework – precisely what the Commission has been trying to move away from for the more than a decade. *See id.* ¶ 33.

144 *See Notice* at 2036 ¶ 131. These comments also respond to the Ex Parte submitted by the eCommerce & Telecommunications User Group ("eTUG") and the Telecommunications Committee of the American Petroleum User Group ("API"), on May 10, 2005, supporting adoption of an interim X-factor of 5.3%. *See* Letter from C. Douglas Jarrett, Keller and Heckman LLP, and Brian R. Moir, eCommerce & Telecommunications User Group, to Marlene Dortch, Secretary, FCC, WC Docket No. 05-25, at 1 (filed May 10, 2005).

proposal is designed to address: a concern that ILEC rates of return are excessive.[145] In any event, imposing the 5.3% figure, plucked from the wastebin of a discarded regulatory regime, would be arbitrary in the extreme. While it is true, as the Commission notes, that the D.C. Circuit once upheld that factor, that was *ten years ago*, and the 5.3% figure was itself based on productivity studies conducted for periods even longer ago than that, on a record the Commission itself conceded was insufficient.[146] Moreover, the figure was calculated for *all price-cap services*, not special access alone.[147]

In short, there could be no basis on which to conclude that this 5.3% figure is at all relevant to any increased productivity experienced by *today's* carriers in their provision of *special access* services, a market that has changed beyond recognition over these past ten years.[148] While the Commission is entitled to some leeway with respect to "interim" decisions, such decisions still require a basis in fact and logic — and there would be none here.[149] Finally,

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145 *See Notice* at 2036 ¶ 131.

146 *See Bell Atlantic*, 79 F.3d at 1200-01.

147 *See id.*

148 *See* Klick & Baranowski Decl. ¶ 31.

149 *See, e.g., Competitive Telecoms. Ass'n v. FCC*, 87 F.3d 522, 526, 532, 533 (D.C. Cir. 1996) (holding that Commission's interim rate structure governing access charges paid to local exchange carriers was arbitrary and capricious where "[t]he Commission has not shown either that its allocation is cost-related or that a departure from a cost basis is justified," and directing the Commission either to return to cost-based system or else to "provide a reasoned explanation of why a departure from cost-based ratemaking is necessary and desirable in this context"; and finding that the Commission "still has not justified its use of the overhead allocated to switched access" because its explanation, while arguably valid in the past, "is no longer an acceptable justification"); *Union of Concerned Scientists v. Nuclear Regulatory Comm'n*, 711 F.2d 370, 379 (D.C. Cir. 1983) (vacating NRC's interim rule concerning electrical equipment at nuclear power plants where rule was based on factual determination that was not supported by a record developed with notice and comment); *Air Transp. Ass'n of Can. v. FAA*, 254 F.3d 271, 279 (D.C. Cir. 2001) (holding that FAA interim fee schedule was arbitrary and capricious because the FAA unreasonably adopted a key cost assessment assumption not supported by any record

if it adopted this 5.3% "interim" solution, the Commission would be ratcheting down LECs' prices, using a totally arbitrary number, before even determining that the prices to be reduced are too high to begin with.[150] The Commission would then have to ensure that it could determine how to correct this error, and compensate the ILECs, when it later determines that there is in fact no basis for such downward adjustments.[151] For all of these reasons, the whole approach is unlawful and ill-advised.

4. For similar reasons, the Commission also should reject the idea of reimposing a "g-factor."[152] The *Notice* suggests that the ARMIS data support the use of a g-factor because the data show that the ILECs are experiencing cost benefits derived from economies of scale.[153] But for all the reasons already provided, ARMIS data provide no basis to reach that conclusion, because they inaccurately depict how investment and costs have increased with demand.[154] Nor, for the same reasons, would those data allow calculation of a relevant g-factor.[155] Indeed,

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justification); *Fresno Mobile Radio, Inc. v. FCC*, 165 F.3d 965, 970 (D.C. Cir. 1999) ("Because the Commission has failed to articulate a satisfactory explanation for its refusal to extend the Interim Coverage Requirement to wide-area SMR licensees, we hold that its decision was arbitrary and capricious in that respect."); *Illinois Pub. Telecomms. Ass'n v. FCC*, 123 F.3d 693, 694 (D.C. Cir. 1997) (vacating the commission's order that companies with annual toll revenues in excess of $100 million pay the full amount of the compensation due from all of the companies during an interim plan because "the FCC did not adequately justify why it based its interim plan on total toll revenues, as it did not establish a nexus between total toll revenues and the number of payphone-originated calls") (citation omitted).

150 *See* Klick & Baranowski Decl. ¶ 32.

151 *See id.* ¶ 33.

152 *See Notice* at 2009 ¶ 38.

153 *See id.* at 2009-10 ¶¶ 38-40.

154 *See* Section I.C, *supra.*

155 *See id.* And as the *Notice* itself seems to recognize, this would involve complicated "equivalency" calculations among various special access services, a process that inevitably would embroil the industry in endless disputes.